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No. 87-1870

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1988

ESTATE OF HARLAN O'LEARY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners contend that under the cost-recovery method of accounting for gain or loss on an installment sales contract, they are entitled to apply payments of interest as well as principal against recovery of their entire basis in the property sold, before reporting any interest income.

1. Harlan O'Leary was in the business of subdividing and selling unimproved desert land, with payments to be made on an installment basis. The contracts of sale called for monthly payments of principal and interest over periods varying from 13 to 20 years. For federal income tax purposes, the O'Learys used the cost-recovery method of reporting gain or loss from sales.[1] As set forth in Treas. Reg. § 1.453-6(2), that method of accounting is available when the installment obligations are found to have no ascertainable market value; it allows the vendor to apply

[1] Eloice O'Leary is a party to this case by virtue of having filed a joint federal income tax return with her husband, Harlan.

payments received to reduce the basis of the property sold, without reporting any income until the installment payments exceed the basis. Petitioners applied payments of both principal and interest made under the sales contracts against their basis in the respective properties, before reporting any income. Pet. App. A2-A5.

The Commissioner did not dispute that the O'Learys were entitled to use the cost-recovery method of accounting for their gains on the sales. He determined, however, that the method was applicable only to the periodic payment of principal received to pay for the land, not to the interest portion of each payment. Therefore, only the principal payments should have been applied to reduce O'Leary's basis in the properties sold; the interest payments should have been reported as ordinary interest income. Accordingly, the Commissioner asserted deficiencies of $49,795 for 1978 and $73,085 for 1979. Pet. App. A1. The O'Learys filed a petition in the Tax Court seeking a redetermination of the deficiencies.

The Tax Court upheld the Commissioner's determination (Pet. App. A1-A16). The court explained that "petitioners had no cost basis in the interest payments which they received, and such payments were fully reportable in the year of receipt" (*id.* at A10). The court found that petitioners "unilaterally attempted to convert interest payments into principal payments" (*ibid.*), which goes beyond what is permitted under the cost-recovery method. The court of appeals affirmed without opinion (*id.* at A19).

2. The courts below correctly rejected petitioners' contention that the interest payments under the installment sales contracts could be applied to reduce O'Leary's basis in the land, rather than currently reported as interest income. The cost-recovery method applied by petitioners is a

special method of accounting that can be used for reporting gain or loss on the sale of property – when the payment obligations have no ascertainable market value (usually because they are contingent). Because that method of accounting is designed only to determine gain or loss on a sale of property, it has nothing to do with the taxation of interest payments received in connection with payments for that sale. The installment payments of principal, which are portions of the purchase price of the property and therefore are an element of the computation of gain or loss on the sale, may be applied to reduce the basis of the property under the cost-recovery method. See *Burnet* v. *Logan*, 283 U.S. 404 (1931). But the interest payments, which are essentially compensation for the delay in paying the purchase price but do not represent a portion of that purchase price, are not an element of the computation of gain or loss on the sale and should not be applied to reduce the basis of the property. Rather, the interest payments should have been included in gross income, which is the way interest is usually treated under the Internal Revenue Code (see 26 U.S.C. 61(a)(4)). See generally *United States* v. *Santarelli*, 778 F.2d 609, 616-617 (11th Cir. 1985); *Rodney* v. *Commissioner*, 53 T.C. 287, 312-313 (1969).[2]

Petitioners claim (Pet. 10-12) that the decision below conflicts with *Liftin* v. *Commissioner*, 36 T.C. 909 (1961),

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[2] This distinction between interest and principal payments has generally been recognized and honored by taxpayers, which accounts for the paucity of decisions on the precise issue presented here. Taxpayers invoking the cost-recovery method of accounting routinely report the interest component of a payment as currently taxable income; the litigation focuses on the question whether the obligations lack an ascertainable fair market value such that the cost-recovery method is available. See, *e.g.*, *Estate of Wiggins* v. *Commissioner*, 72 T.C. 701 (1979); *Underhill* v. *Commissioner*, 45 T.C. 489 (1966); *Darby Inv. Corp.* v. *Commissioner*, 315 F.2d 551 (6th Cir. 1963).

aff'd, 317 F.2d 234 (4th Cir. 1963), *Willhoit* v. *Commissioner*, 308 F.2d 259 (9th Cir. 1962), and *Phillips* v. *Frank*, 295 F.2d 629 (9th Cir. 1961). As the Tax Court explained (Pet. App. A9-A10), however, those cases are clearly distinguishable from this one, and petitioners make no effort to rebut the Tax Court's distinction. In the cases relied upon by petitioners, the taxpayer was not the original seller of the property; rather, the taxpayer had purchased the installment obligation from the original seller at a discount. Thus, it was the debt obligation itself in which the taxpayer had a cost basis, and it was the purchase of the debt obligation on which the taxpayer was required to determine gain or loss. The courts held that, in these circumstances, the taxpayer was allowed to apply the entire installment payment to reduce the cost basis in the purchased obligation, before reporting any income as gain on the purchase. Whether characterized as principal or interest to the original seller, the full installment payment in the hands of the taxpayer represented a return on his investment in purchasing the obligation and therefore could appropriately be applied to reduce his cost basis in the purchased obligation. Here, by contrast, the interest component of the payment is simply the ordinary incident of what is essentially a loan from the taxpayer to the purchaser of the property (*i.e.*, permitting him to pay on an installment basis). The interest is not part of the payment for the purchased property, and therefore it should not be applied to reduce its cost basis.

Petitioners also rely (Pet. 8-10) upon *Helvering* v. *Drier*, 79 F.2d 501 (4th Cir. 1935), and *Commissioner* v. *Speyer*, 77 F.2d 824 (2d Cir.), cert. denied, 296 U.S. 631 (1935). In those cases, payments received by taxpayers from the Mixed Claims Commission to compensate for the loss of property seized by Germany during World War I were

held not to constitute income, notwithstanding the fact that the Commission had designated part of the sums paid as interest, where the payment was contingent on unpredictable circumstances and the amounts received did not exceed the value of the property. The courts concluded that the payments, including the component designated as interest, were more comparable to the contingent obligations involved in *Burnet* v. *Logan, supra*, than to the payment of interest on a fixed obligation. The special circumstances of these cases—particularly, the doubts repeatedly expressed by the courts as to whether the statutory interest designation should be regarded as controlling the characterization of the payments for federal income tax purposes (see, *e.g., Morgan Guaranty Trust Co.* v. *United States*, 585 F.2d 988, 995-996 (Ct. Cl. 1978))—renders them inapposite here.[3]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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[3] The IRS adopted the position taken by the courts in *Drier* and *Speyer*. See G.C.M. 16166, 15-1 C.B. 175 (1936). That ruling was later declared obsolete in the course of a review of the continuing vitality of all pre-1953 rulings. See Rev. Rul. 67-406, 1967-2 C.B. 420, 425.

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